STATE OF CALFORNIA
ELECTRICITY OVERSIGHT BOARD

Gray Davis, Governor

August 16, 2002

VIA ELECTRONIC DELIVERY FOR FILING

Hon. Magalie R. Salas, Secretary
Federal Energy Regulatory Commission
888 First Street, NE
Washington, D.C. 20426

Re: California Independent System Operator Corporation,
Docket No. ER02-1656-000

Dear Ms. Salas:

The Electricity Oversight Board hereby submits for filing electronically its Request for Rehearing of the Order on the California Comprehensive Market Redesign Proposal issued in the above-referenced docket on July 17, 2002.

Thank you for your assistance.

Sincerely,

/s/

Grant A. Rosenblum
Senior Staff Counsel
Electricity Oversight Board

cc: Official Service List of Docket Nos. ER02-1656

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UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

California Independent System Operator Corporation	)	Docket No. ER02-1656-000
	)	
	)	
Investigation of Wholesale Rates of Public Utility Sellers of Energy and Ancillary Services in the Western Electricity Coordinating Council	)	Docket No. EL01-68-017

REQUEST FOR REHEARING OF THE CALIFORNIA ELECTRICITY OVERSIGHT BOARD OF THE ORDER ON THE COMPREHENSIVE MARKET REDESIGN PROPOSAL OF THE CALIFORNIA INDEPENDENT SYSTEM OPERATOR CORPORATION

Pursuant to the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.713, and Section 313 of the Federal Power Act ("FPA"), 16 U.S.C. § 8251, the California Electricity Oversight Board ("CEOB") hereby seeks rehearing in the above-referenced dockets of the Commission's July 17, 2002, "Order on the California Comprehensive Market Redesign Proposal," 100 FERC ¶ 61,060 (2002) ("Redesign Order").

I.

INTRODUCTION AND SPECIFICATION OF ERROR

The Commission's consideration of the California Independent System Operator Corporation's ("CAISO") Comprehensive Market Redesign Proposal ("MD02") must be placed in the context not only of the desired future structure of the California electricity market, but also of the market's recent disastrous past and its continuing dysfunctional present. The Redesign Order reflects a failure to properly do so.

The collapse of California's wholesale electricity markets began in May 2000. In June 2000, energy prices soared to $147/MWh, or more than five times the price for June of the previous year. The arrival of cooler weather and the accompanying seasonal reduction in demand failed to restrain prices. The average energy price in December 2000 reached the unthinkable level of $294/MWh. The crisis reached its apex in the spring of 2001. Average real-time prices in March and April exceeded $300/MWh and averaged $250/MWh in May. The total cost of energy from May 2000 to May 2001 surpassed $40 billion, compared to $7 billion for 1999. The California Independent System Operator Corporation ("CAISO") calculated that approximately $9 billion reflected supplier revenues in excess of reasonable competitive levels. Throughout this year-long exploitation of California consumers, and amid numerous requests by the CEOB and others for aggressive action, the Commission remained inert or impotent.[1] It was not until the issuance of the Commission's June 19, 2001 Order[2] that California and the rest of the West received any meaningful relief.

The Commission once again appears ready through the Redesign Order to expose California consumers to potentially unjust and unreasonable prices and market abuses.

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1 The Commission did act in an attempt to address the dysfunctions in the California market primarily through two orders, *San Diego Gas & Electric Co.,* 93 FERC ¶ 61,294 (2000) (December 15 Order) and *San Diego Gas & Electric Co.,* 95 FERC ¶ 61,115 (2001) (April 26 Order). However, as noted by the CEOB in its requests for rehearing of those orders, the limited scope of the mitigation proposed in the December 15 Order and April 26 Order greatly undermined the efficacy of the relief offered to California consumers. The CEOB also acknowledges that the Commission has provided California with a substantial remedy, albeit incomplete because of the exclusion of certain bilateral spot transactions, through the refund proceeding initiated by *San Diego Gas & Electric Co.,* 96 FERC ¶ 61,120 (2001) (July 25 Order).

2 *San Diego Gas & Electric Co.,* 95 FERC ¶ 61,418 (2001).

The Commission recognizes that California's wholesale energy market remains uncompetitive and susceptible to a reoccurrence of price spikes. Critical infrastructure changes and other market improvements, both within the Commission's jurisdiction and within the control of other policy-makers, remain immature but must be fully developed to create a workably competitive market. Recent revelations confirm that energy prices in California are vulnerable to manipulation by gaming strategies and the exercise of market power absent competitive conditions.[3] Yet, the Redesign Order errs by ignoring the serious implications of the admitted reality that California's electricity market is not presently competitive and will not be for some time.

This fundamental flaw in the Redesign Order infects its treatment of the CAISO's Phase I elements, which include design elements that are necessary to mitigate against the exercise of existing market power and therefore must replace the present Commission approved mitigation measures set to expire on September 30, 2002.[4] By discounting the continued dysfunction and lack of competitiveness of California's markets, the Commission has adopted mitigation measures that are too relaxed to effectively prevent the exercise of market power and ensure just and reasonable rates. Thus, while there are positive elements of the Redesign Order that the CEOB fully supports, such as the extension of the West-wide must-offer requirement and bid cap (but not the level), real-

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[3] See, *Fact-Finding Investigation of Potential Manipulation of Electric and Natural Gas Prices,* Docket No. PA02-2-000 (August 2002).

[4] The CAISO proposed to implement MD02 in three phases. Phase 1 includes a must-offer requirement, bid cap, automatic mitigation procedures, local market power mitigation, as well as a residual unit commitment , real-time economic dispatch, single energy curve, deviation penalties, and a 12-month competitive index. Phase 2 contained design reforms related to the creation of a day-ahead market and congestion management. Phase 3 involved implementation of the detailed network model and redesign of firm transmission rights. The CAISO proposed to implement Phases 2 and 3 in the spring of 2003 and fall 2003/winter 2004, respectively.

time economic dispatch reforms, and penalties for uninstructed deviations, the Redesign Order contains the following specific errors:

1. The bid cap level selected by the Commission is contrary to law in that it fails to ensure just and reasonable prices as mandated by the Federal Power Act ("FPA) and is unsupported by the record and therefore is arbitrary and capricious.

2. The automatic mitigation procedures ("AMP") adopted by the by the Commission are contrary to law in that they fail to ensure just and reasonable prices as mandated by the FPA because of the thresholds selected for triggering mitigation and because of the unsuitability of applying AMP to mitigate local market power. Further, the AMP thresholds are not supported by evidence in the record.

3. The failure to adopt the proposed 12-month market competitiveness index is contrary to the Commission's obligation under the FPA to ensure just and reasonable prices.

4. The decision to expedite aspects of Phase 2 elements of the CAISO's proposal is not supported by the record.

II.

THE COMMISSION MUST REVERSE ITS DECISION TO SET THE DAMAGE CONTROL BID CAP AT $250

As part of its Phase 1 mitigation measures, the CAISO proposed a bid cap of $108 that could adjust upward to accommodate increases in the cost of natural gas. The bid cap would operate to limit the maximum bid allowed in the CAISO energy and ancillary services markets. The CAISO established the bid cap level based on the reality that California's wholesale electricity markets are not competitive and that many of the market redesign elements and structural reforms necessary to improve competitiveness require substantial time to take effect or are not within the CAISO's authority to implement. The Commission rejected the CAISO's proposal and, instead, set an initial bid cap of $250. The Redesign Order erred because the Commission adopted bid cap does not ensure just and reasonable prices and the purported justifications for the bid cap level are not supported by the record and are arbitrary and capricious.

A. The Damage Control Bid Cap Violates the Federal Power Act By Failing To Ensure Just and Reasonable Rates

The primary responsibility of the Commission is to "guard the consumer against excessive rates." (*City of Detroit v. FPA,* 230 F.2d 810, 817 (D.C. Cir. 1956).) Rates for wholesale power must therefore be "just and reasonable." (16 U.S.C. §§ 824d, 824e.) The bid cap is intended to establish a ceiling on market rates in CAISO markets. It follows that market rates up to and including the bid cap must represent just and reasonable prices. The Federal Power Act ("FPA") fails to prescribe how just and reasonable rates must be determined. Mere deference by the Commission to prevailing market prices, however, represents an impermissible abandonment of its regulatory obligations under the FPA. (*FPC v. Texaco,* 417 U.S. 380, 397 (1974).) Instead, rates determined by market conditions may be utilized only where the Commission can make sufficient findings that the relevant market is, in fact, competitive, or prices otherwise emulate the outcomes expected from a competitive market. (*Elizabethtown Gas Company v. FERC,* 10 F.3d 866, 870 (D.C. Cir. 1993).) Neither of these circumstances exists here.

1. The Commission Has Acknowledged That The California Electricity Market Is Not Competitive

The court in *Elizabethtown* upheld the Commission's approval of market-based rates for gas sales by a natural gas pipeline on the ground that the Commission had "specifically found" that gas sales markets "were sufficiently competitive to preclude [the pipeline] from exercising significant market power" such that the pipeline would "not be able to raise its price without losing substantial business to rival sellers." (*Id.* at 871.) Thus, where the Commission permits market derived pricing, the Commission must have "empirical proof" that "existing competition [did] ensure that the actual price is just and reasonable." *Farmers Union Central Exchange, Inc. v. FERC,* 734 F.2d 1486, 1503 (D.C. Cir. 1984); see also, *Tejas Power Co. v. FERC,* 908 F.2d 998, 1005 (D.C. Cir. 1990).

The Commission has not, and cannot, establish that existing competition in California electricity markets can ensure just and reasonable prices. Indeed, the Commission admits that the wholesale electricity market in California remains uncompetitive and susceptible to extreme price spikes and that California's current market stability is likely to be temporal in nature.[5] Furthermore, the Redesign Order notes that many of the elements necessary to support a competitive market, including new approaches to reserve requirements, additional generation and transmission capacity, demand bidding and ability of load serving entities to forward contract,[6] "will not be

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[5] Redesign Order, slip. op. at 2 ["the California wholesale electricity market has been dysfunctional and has experienced extremely high prices during certain periods"]; at 3 ["These conditions, which are a mixture of market design flaws and inadequate infrastructure, must be corrected for a robust, competitive California market to evolve in the long run"]; at 3 ["Many of the factors contributing to this improvement in the market place are likely temporal in nature and cannot be expected to continue in the long term…"].

[6] The State of California is diligently working to develop demand response programs and return the investor owned utilities to creditworthy status. (See, CPUC Rulemaking 01-10-24.) Nevertheless, the

effective by October 1, 2002"[7] and "require coordinated efforts over a longer period of time."[8] Thus, the record demonstrates that the California market is not competitive and will not be any more competitive on October 1, 2002, than it is now. Currently, the Commission has determined that the appropriate bid cap is $91.87/MW. Under such circumstances, the Commission has failed to establish any reasonable factual basis to justify its decision to raise the bid cap from $91.87/MW[9] to $250/MW overnight.

2. The $250 Bid Cap Is Excessive When Compared To Commission's Findings Regarding Competitive Market Behavior

In the absence of a competitive market, the question becomes whether a price of $250 would be an outcome consistent with a competitive market in California. True competitive markets produce just and reasonable rates because, like rates determined on the basis of the seller's cost-of-service, competitive market prices will fall within the zone of reasonableness by approximating the seller's actual costs. As the D.C. Circuit explained:

> In a competitive market, where neither buyer nor seller has significant market power, it is rational to assume that the terms of their voluntary exchange are reasonable, and *specifically to infer that the price is close to marginal cost, such that the seller makes only a normal return on its investment.*

(*Tejas Power Corp. v. FERC,* 908 F.2d at 1004.)

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ability of the State to ensure that PG&E regains its ability to fully serve its load is impacted, and likely restricted, by that entity's ongoing bankruptcy proceeding.

7 Redesign Order, slip. op. at 16.

8 Redesign Order, slip. op. at 3.

9 *Order on Rehearing, Reconsideration and Clarification,* Docket Nos. EL00-95-058, et al. (July 11, 2002).

Accordingly, while the Commission possesses discretion in selecting ratemaking methods, and by extension bid caps, the determination whether the bid cap will fall within the zone of reasonableness must be measured against costs incurred by sellers in the relevant market. "Because the relevant costs, including the cost of capital, often offer the principal points of reference for whether the resulting rate is 'less than compensatory' or 'excessive,' the most useful and reliable starting point for rate regulation is an inquiry into costs." (*Farmers Union Central Exchange, Inc. v. FERC,* 734 F.2d at 1502; see also, *City of Chicago v. FPC,* 458 F.2d 731, 751 ["[W]hen the inquiry is whether a given rate is just and reasonable to the consumer, the underlying concern is whether it is low enough so that exploitation by the producer is prevented … [N]o factors apart from the producers' costs are available to guide efforts to make that determination from the standpoint of consumers." (Emphasis in original).]

Consistent with judicial precedent, the Commission has repeatedly affirmed its acceptance of the rule that competitive markets clear at the marginal cost of the highest cost unit needed to meet demand.[10] The methodology underlying the July 19 Order was intended to emulate the results of a competitive market by estimating the marginal cost of the marginal unit. Under that methodology, and under conditions of scarcity, i.e., a reserve deficiency, the Commission established an original mitigated price of $108/MWh, which was based on a gas index of $6.64/MMBtu, a generating unit with a heat rate of approximately 15,360 Btu/MWh, and a $6 O&M adder.[11] Cost conditions are now more favorable. The midpoint daily spot gas price at Malin and SoCal Gas on

[10] See, e.g., *San Diego Gas & Electric Co., et al.,* 96 FERC ¶ 61,418 (2001) (June 19 Order); *San Diego Gas & Electric Co., et al.,* 97 FERC ¶ 61,275 (2001) (December 19 Order).

August 14, 2002, was $2.65 and $2.83, respectively.[12] Consequently, even assuming a marginal unit with a heat rate of 20,000 Btu/MWh, its marginal cost would be approximately $63, or well within the CAISO's proposed bid cap, which could be adjusted to meet rising gas costs.

As noted, the competitive conditions of California's energy markets will not change at midnight on September 30, 2002, when the proposed bid cap becomes effective. Yet, the same generator that could not submit a just and reasonable bid above $91.87/MW[13] on September 30, 2002, could overnight potentially receive $250/MW without CAISO or Commission scrutiny.[14] Thus, despite no change in fundamental market conditions, that generator could obtain a return on capital of $187/MW.[15] Other infra-marginal generators will obtain an even greater windfall. There is no justification for such an excessive divergence from the expected outcome of a competitive market and, therefore, the resulting rate is necessarily unjust and unreasonable.

B. The Purported Justifications For The Damage Control Bid Cap Of $250 Are Not Supported By The Record

The Commission lists three grounds supporting its selection of the bid cap level: (1) a lower bid cap will increase the number of out-of-market ("OOM") transactions; (2)

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11 *Investigation of Wholesale Rates of Public Utility Sellers of Energy and Ancillary Services in the Western Systems Coordinating Council,* 97 FERC ¶ 61,294 (2001).

12 Platts Energy Trader, West, August 15, 2002.

13 *Order on Rehearing, Reconsideration and Clarification,* Docket Nos. EL00-95-058, et al. (July 11, 2002).

14 The CAISO's proposed AMP will only mitigate if the effect of acceptance of the bid on the MCP does not exceed the threshold level. If other pivotal generators also exercise market power, the AMP may not operate to mitigate the bids.

15 As noted below, this amount is far in excess of the revenue requirement to warrant investment in new capacity.

a lower bid cap will not provide sufficient incentive for investment in new capacity; and (3) the reduced volume in the spot market minimizes the adverse consequences on California. Again, none of these justifications can be supported.

1. The Commission's Concern Regarding An Unreasonable Increase In OOM Transactions Is Eliminated By Imposition of The West-Wide Must Offer Requirement And Extension of The Bid Cap To All Spot Transactions In The West

The Commission agreed with the Market Surveillance Committee ("MSC") that a $108/MWh bid cap would be detrimental to California's energy and ancillary services markets because the bid cap would provide an incentive for "significant amounts of OOM purchases that will take the form of a non-transparent, pay-as-bid market, thus negating the effectiveness of market forces to limit prices."[16] The Commission further stated that it "believes a low bid cap would create a disincentive for out-of-state suppliers to bid into the California market."

The Commission has misconstrued the MSC. The Commission's error arises from its failure to appreciate that the MSC's discussion regarding increased OOM assumes there is no West-wide must offer or uniform bid cap. This is clear from the following comment:

> Unless FERC orders generation unit owners, including those in neighboring control areas, to bid all of their capacity into the California market at prices at or below the DCBC, the ISO faces this tradeoff in setting the DCBC. Even if FERC continues the must-offer requirement with a low DCBC, generation unit owners have an incentive to leave units without forward schedules and declare forced outages in order to increase the likelihood that the ISO makes OOM calls.[17]

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[16] Redesign Order, slip. op. at 21.

[17] Supplementary Comments on the 2002 Market Design Proposal of the California ISO, MSC, May 24, 2002.

Thus, contrary to the Commission's perception, the MSC recognized that extension of the West-wide must-offer requirement and uniform bid cap eliminated the ability to arbitrage between California markets and neighboring control areas and to legitimately force OOM transactions by physically withholding supply. In fact, the MSC notes that the only way to compel OOM calls under the circumstances in the Redesign Order would be for suppliers to "declare forced outages." As the Commission has readily stated in the context of its Fact Finding Investigation of Potential Manipulation of Electric and Natural Gas Prices, Docket No. PA02-2-000, confidence can only be restored in the energy markets if the Commission intends to prevent and prosecute anti-competitive gaming behavior. It should not raises prices to California consumers merely to avoid confrontation with generators over market manipulation.

Further, the Commission notes "application of the bid cap West-wide should eliminate incentives for 'megawatt laundering.'"[18] Imports cannot avoid mitigation merely by attempting to force a bilateral spot transaction. "If such [OOM] purchases spot market transactions from resources subject to our market power mitigation measures, however, OOM transactions are subject to the West-wide price mitigation cap."[19] Given this uniformity in the price cap, imports will be indifferent to the location of its sales such that the $108/MWh price cap will not provide any disincentive for imports to participate in the CAISO markets.

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18 Redesign Order, slip. op. at 22.

19 Redesign Order, slip. op. at 22, fn. 37.

Finally, the reality is that the current lower bid cap of $91.87 coupled with the current West-wide must-offer requirement has not resulted in substantial OOM transactions. The CAISO recently reported:

> ISO operators resorted to OOM calls in 29 of 720 hours in June (2002). These hours fell into two categories. Most were late-night or morning-ramp hours in which scheduling coordinators (SCs) had scheduled generation in excess of actual load, which forced the ISO to make decremental OOM calls after exhausting DEC bids into the BEEP Stack, to compensate for overscheduling.[20]

Accordingly, the Commission's purported concern regarding the threat of increased OOM transactions is unsupported by the record.

2. A $108/MWh Bid Cap Will Not Obstruct Investment In New Capacity

The Commission states that its $250 bid cap constitutes a balance between the need to provide an incentive for market entry and the need to protect against market power abuse. As noted above, the Commission's bid cap does not do the latter, and is irrelevant to the former. A high bid cap only increases profits for existing firms. Developers of new resources understand that the increase in supplies they will bring to the market will reduce spot prices. Therefore, new generation does not effectively respond to high spot prices. Instead, the financing for new generating resources requires and relies on the stability and duration of an anticipated revenue stream. Such stability is only effectively provided through bilateral contracts. The CAISO has confirmed this view:

> While others may argue that the existing price mitigation is restrictive and limits incentives for infrastructure investment, the ISO strongly believes

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[20] California Department of Market Analysis, Market Analysis Report for June 2002 (July 26, 2002), at 3.

that it is in the forward energy markets - the long-term markets - where investors will demand that sufficient incentives for investment exist. Over the last several years, the industry has moved away from project-specific financing to the financial backing of developers that offer, as collateral, a safer, more diversified portfolio of assets. Moreover, investors are requiring that developers rely upon a stable, long-term revenue stream, as opposed to unpredictable spot market revenues. This evolution has taken place not because of price mitigation measures in spot markets, but because the financial industry is seeking a more conservative and hence stable, investment strategy."[21]

3. The Reduced Volume In The CAISO's Spot Market Cannot Justify The Harm Resulting From The $250/MWh Bid Cap

The Commission attempts to justify the $250/MWh bid cap on the ground that it "should have a very different impact on the California and Western market and customers than it did in 2000."[22] There are two fatal errors in the Commission's reasoning. First, the FPA does not excuse certain unjust and unreasonable rates simply because the unlawful transactions do not have a material impact on the market in the aggregate. The FPA renders each single unjust and unreasonable rate illegal. (16 U.S.C. §§ 824d, 824e.) Second, there is no assurance that the volume of energy procured in the spot market will remain as small of a percentage of California's overall energy needs as it is currently. The authority granted by the Legislature to CERS to purchase the net short of the IOUs expires on December 31, 2002. At that time, the IOUs will hopefully resume their traditional role of serving load. Their ultimate ability to do so remains uncertain due, in large part, to continuing questions regarding creditworthiness. Moreover, any requirement that the IOUs immediately procure a specified percentage of energy in the

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21 CAISO MD02 Transmittal Letter (May 1, 2002), at 2.

22 Redesign Order, slip. op. at 22.

forward market will likely act to merely transfer the existing market power of suppliers from the spot to forward markets. Consequently, if the IOUs are granted flexibility in the short-term to procure in the manner most advantageous to them, including purchases in the spot market, the volume in the spot market may fluctuate from current levels.

III.

THE REDESIGN ORDER RENDERS THE AMP PROCEDURES IMPOTENT TO MITIGATE ECONOMIC WITHHOLDING AND IS ARBITRARY AND CAPRICIOUS

The CAISO proposed to apply automatic mitigation procedures ("AMP") to mitigate economic withholding. The AMP uses two screens. The first screen, or conduct screen, evaluates bids for market conduct that is inconsistent with workable competition. The second screen, or impact screen, evaluates bids to determine whether the bids will have a substantial impact on market prices. If both conditions are met, bid mitigation is imposed on the unit automatically. The conduct screen is based on a reference price. Under the CAISO's proposal the reference price would first be set by looking to the resources historical bids and if a particular bid exceeds the reference price by the lesser of 100% or $50/MWh and acceptance of the bid would raise the market price by the lesser of 100% or $50/MWh, AMP is triggered.

The Commission accepted the AMP procedures generally, but relaxed the thresholds proposed by the CAISO and imposed a minimum price screen of $91.87.[23] In doing so, the Commission improperly calibrated for California. The CAISO correctly noted that the generous thresholds developed by the NYISO are inappropriate for

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[23] Redesign Order, slip. op. at 28-31.

California. In contrast to the NYISO, which operates in a reasonably competitive market, the Commission has found that the current California electricity wholesale market is not workably competitive. As such, the Commission's adopted thresholds are too generous to impose any real discipline on the California market. This is especially true given the CAISO's and Commission's preference for using suppliers' own accepted historical bids to establish the reference point for determining excessive bids. The use of suppliers' own accepted historical bids reduce the efficacy of AMP. Historical bids in California reflect the rampant exercise of market power and thus any reliance on such bids will result in initial AMP levels that incorporate the outcome of anticompetitive market behavior and thereby exacerbating the adverse impact of the Commission's excessive thresholds. In fact, the CAISO has confirmed that even the June 19 Order has not ensured that accepted bids are competitive.

> …. investigation of the real time market revealed that even after the implementation of the June 19 Order the real-time market is not competitive during many hours and successful bids in such a market are not a good proxy for competitive reference bid prices.[24]

Moreover, the use of a bid-based reference point can be gamed. Suppliers can cause recalculations over time that act to artificially inflate the reference point.[25]

Similarly, the Commission's decision to impose a minimum price screen of $91.87/MWh is unjustified. There is no evidence in the record that prices below this level are necessarily immune from the influence of market power. Moreover, until the

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[24] CAISO's MD02 Filing (May 1, 2002), at 141.

[25] If, however, historical bids are ultimately adopted to set the reference point for AMP, then the Commission must require that the underlying bids come from a period when the CAISO's new Market Competitive Index, which the Commission has directed the CAISO to file on a weekly basis, had not been violated. According to information provided by the CAISO, the only period of acceptable bids extends from April 1999 to April 2000.

reference prices are developed and evaluated, the price screen has no rational foundation or point of departure. It is necessarily arbitrary. Finally, the setting of the minimum price screen will tend to incent efficient suppliers to gradually increase their bids up to the screen and thereby operate to elevate the price of the less efficient suppliers and the entire market. Accordingly, the Commission should adopt the AMP thresholds proposed by the CAISO and eliminate the minimum price screen.

IV.

APPLICATION OF THE AMP PROCEDURES TO MITIGATE LOCATIONAL MARKET POWER IS ARBITARY AND CAPRICIOUS

The CAISO proposed a local or intra-zonal market power mitigation plan that would mitigate bids of those units that must be dispatched out of merit order to alleviate intra-zonal congestion - after first relying on “reliability must-run” units - by capping the bid at the generating unit’s short-run variable cost. The CAISO’s plan mirrors the authority granted by the Commission to PJM. Nevertheless, the Commission rejected the CAISO’s proposal and, instead, directed the CAISO to apply modified AMP procedures to test for local market power. Under the modified AMP procedures, any bid less than $91.87/MWh taken out of merit order is exempt from mitigation, but out of merit order bids greater than $91.87/MWh will be assumed to have failed the conduct test and will be tested for market impact (i.e., whether the bid is $50/MWh or 200% greater than the MCP). If the bid fails the impact test, the generator will be paid the higher of its reference price or the market-clearing price.[26]

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[26] Redesign Order, slip. op. at 35.

The Commission's decision to exclusively rely on AMP procedures to mitigate local market power lacks a rational basis and fails to ensure just and reasonable prices. The Commission asserts that the value of AMP is its ability to differentiate between the exercise of market power and purported scarcity prices.[27]The Commission also correctly recognizes that transmission constraints or concentration of generation may give rise to situations where the number of bids available to alleviate congestion and ensure reliability is insufficient to be considered competitive. Those generators are therefore in a position to exercise market power.[28] This highlights the inappropriateness of applying AMP in context of mitigating intra-zonal congestion costs. Simply put, there is nothing for AMP to differentiate – the Commission acknowledges the existence of market power. Yet, despite this understanding, the Commission is allowing units with local market power to bid at a minimum $91.86/MWh regardless of the MCP, or possibly up to $49.99 above the MCP, and know their bids must be accepted without mitigation. Guaranteeing such profits is clearly unsupportable.[29]

The Commission further improperly relies on the testimony of the MSC in choosing to apply AMP in the context of intra-zonal congestion and local market power. The MSC does strongly support the implementation of an automatic mitigation procedure on all generating units that possess local market power as determined by clearly

[27] Redesign Order, slip. op. at 31.

[28] Redesign Order, slip. op. at 34.

[29] While it is true that the NYISO has proposed, and the Commission, has accepted applying AMP procedures to constrained load pockets, the NYISO's mechanisms for mitigating local market power in New York City differ significantly from the AMP parameters adopted for California. First, the NYISO does not apply a minimum bid screen when there is congestion. Second, when congestion occurs the NYISO imposes substantially lower conduct and impact thresholds that mitigate bids that exceed the reference by 2%. (*New York Independent System Operator, Inc.,* 99 FERC ¶ 61.246 (2002), slip.op. at 23-24.) Thus, the Redesign Order is wholly inconsistent with prior Commission orders and the Commission has provided no justification for its divergence.

articulated criterion. However, unlike the Commission's AMP procedures, the MSC does not view the mitigation to be conditional on bid price if local market power exists. Rather, the MSC recommends, as an example, that "if the ISO determines that at most three generation owners are able to provide a local energy need, then the bids submitted by these market participants will be subject to an AMP."[30]

V.

THE COMMISSION ERRED BY FAILING TO APPROVE THE CAISO'S PROPOSED 12-MONTH MARKET COMPETITIVENESS INDEX

The Redesign Order rejects the CAISO's proposal to create a 12-month market competitiveness index.[31] As part of its comprehensive market power mitigation plan, the CAISO proposed a 12-month rolling average price-cost markup index that measures the difference between actual average market prices and a competitive baseline average cost.[32] If the average market price exceeds the 12-month market competitive index by greater than $5, then certain mitigation measures would be automatically triggered. The index is intended to provide a high level, longer-term evaluation of the overall competitiveness of the market. The Commission's rejection of the 12-month competitiveness index violates the Commission's paramount obligation under the FPA to protect consumers from unjust and unreasonable prices and conflicts with the rationale underlying prior Commission orders.

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30 Comments of the Market Surveillance Committee of the California ISO on the Proposed October 1, 2002 Market Power Mitigation Measures (April 22, 2002), at 5-6.

31 Redesign Order, slip. op. at 38.

32 The CAISO proposed to compute the average market price as the weighted average of day-ahead and real-time energy prices. The competitive baseline average prices would be based on the estimated variable operating cost of the highest cost thermal generation unit within the CAISO system needed to meet system demand each hour.

The rejection of the proposed market index reveals that the Commission has lost sight of its mission. The Commission does not exist to ensure that consumers receive electric power through competitive market mechanisms. Rather, the primary responsibility of the Commission is to "guard the consumer against excessive rates." (*City of Detroit v. FPA,* 230 F.2d 810, 817 (D.C. Cir. 1956). Yet, the Commission in its zeal to shift to a market paradigm ignores that the shift must yield benefits to consumers. The FPA is ideologically neutral. It regulates by results and, as Californians will attest, greater reliance on market mechanisms does not inevitably lead to a reduction in overall costs to consumers. The performance of the market as a whole, not only individual transactions, must be measured to ensure that the benefits promised by the movement toward a competitive market are in fact realized. Otherwise, the Commission improperly turns the FPA on its head by imposing rules that operate to increase the return earned by market participants at the expense of consumers.

VI.

THE COMMISSION'S DECISION TO EXPEDITE ASPECTS OF MD02 IS NOT SUPPORTED BY THE RECORD

The Redesign Order compels the CAISO to expedite the development and implementation of an integrated day-ahead market, ancillary services market reforms, and hour-ahead and real-time market reforms.[33] In doing so, the Commission rejected the CAISO's proposal to implement these "Phase 2" elements of the comprehensive market redesign beginning in May 2003, and, instead, ordered the CAISO to submit revised tariff

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[33] Redesign Order, slip. op. at 39-40.

language by October 21, 2002, for implementation on January 1, 2003.[34] The CEOB agrees that the CAISO's proposed revisions regarding these elements of its redesign plan are critical to improving the efficiency of California's wholesale electric markets and should be implemented as promptly as practical. However, nowhere in the Redesign Order does the Commission cite to any record evidence or offer any analysis that the expedited schedule adopted by the Commission for implementing these elements is feasible, and even if theoretically possible, whether advancing the implementation timeframe will unnecessarily increase development costs, jeopardize quality and accuracy, or expose market participants to unforeseen consequences.

The only comment by the Commission justifying rejection of the CAISO's schedule is that it "does not believe that redesigned elements must be implemented according to the timeline the CAISO proposes."[35] This unsupported conjecture constitutes insufficient evidence to support the outcome of the Redesign Order. Accordingly, while the CEOB shares the Commission's goal of expediting market reform in California, it cannot support rushing the process and potentially triggering unforeseen negative consequences. The Commission, therefore, should remove this uncertainty and error in the record by engaging market participants in further analysis of the costs, consequences and practicality of fulfilling or abandoning its expedited schedule of the Phase 2 elements.[36]

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[34] The Redesign Order states that the "[p]arties will have the opportunity to further comment on these proposals once they are filed." (Redesign Order, slip. op. at 42.) Accordingly, the CEOB limits its comments here to the validity of the Commission's decision to expedite implementation of these Phase 2 elements and reserves its rights to comment on the substance of the CAISO's subsequent filing.

[35] Redesign Order, slip. op. at 17, fn. 28.

[36] At the technical conference sponsored by the Commission held in San Francisco from August 12-15, 2002, there was considerable consensus among market participants that the Commission's expedited

VII.

THE COMMISSION SHOULD ORDER THE CAISO TO FILE ITS OVERSIGHT AND INVESIGATION TARIFF CHANGES

In discussing the need to extend the existing west-wide must-offer requirement, the Commission observed that the CAISO has proposed, or is proposing, many of the structural reforms identified by the Commission as necessary to enhance the efficiency of California's wholesale electricity markets. The CAISO's proposal to file improved market monitoring and investigation tariff language constitutes one such essential reform.[37] Specifically, the CAISO is developing additional authority for market oversight and investigation that includes a process for imposing penalties and sanctions on market participants judged to be in violation of market rules. This aspect of market redesign has taken on added prominence with the revelations that California gas and energy markets suffered from anti-competitive and manipulative trading practices.

As noted, the Commission acknowledged the need to strengthen the CAISO's ability to apply sanctions in instances of market rule violations. The CEOB assumes the CAISO will follow through on its stated intention of filing its proposed tariff language in the near future. The CEOB, however, believes that enhanced market monitoring and enforcement authority constitutes an indispensable component of the CAISO's market redesign such that the Commission should explicitly require as part of an order on rehearing or an independent order that the CAISO make such a filing by a date certain.

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schedule raised serious concerns. Attached as Appendix 1 and incorporated herein is an alternative proposed schedule.

VIII.

CONCLUSION

Based on the foregoing arguments, the CEOB respectfully request that the Commission grant its request for rehearing and modify the Redesign Order in a manner consistent with the arguments herein.

Dated: August 16, 2002

Respectfully submitted,

/s/ *Grant A. Rosenblum*

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[37] Redesign Order, slip. op. at 15.

APPENDIX 1

1. October 1, 2002 - implement the bid cap, AMP methodology, continuation of must
offer, and all the other elements of phase 1 approved in the Redesign Order.

2. January 1, 2002 - Hour-ahead market reforms.

3. Winter 2002/2003 – Development and refinement of Phase 2 and 3 elements through stakeholder participation.

4. Winter 2003 – Single implementation of Phase 2 and 3 elements

Justification:

A. The following proposed schedule provides market participants time to analyze the LMP and simultaneous market outputs. Market participants, i.e., San Francisco, require time to decide how to respond to changes brought about by LMP. Further, the CPUC will have time to conduct a proceeding to shape retail rates and rate design.

B. Complete the decisions and allocation of the FTRs. LSEs require time to analyze how and if FTRs to provide effective hedging tools.

C. Gives time for demand response proceeding at the CPUC to reach completion and to see the outcome so that demand can begin to play a role. LMP outcomes may create a new way of thinking about demand.

D. Provides time for orderly transition between CERS and IOUs.

E. Provides the ISO time to analyze the LMP outcomes and put together a transmission plan to address problems.

CERTIFICATE OF SERVICE

I hereby certify that I have caused, or will cause, the foregoing document to be served upon each person designated on the official service list compiled by the Secretary for this proceeding, pursuant to Rule 2010(a) of the Commission's Rules of Practice and Procedure, on or about August 16, 2002.

Dated at Sacramento, California, this 16th day of August, 2002.

/s/

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